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In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Nos. 94-3714, 94-3856

UNITED STATES OF AMERICA,
PLAINTIFF-APPELLEE/CROSS-APPELLANT

v.

JAMES HERMAN O'HAGAN,
DEFENDANT-APPELLANT/CROSS-APPELLEE

Submitted: October 17, 1995
Decided: Aug. 2, 1996

Before: FAGG, LAY, and HANSEN, Circuit Judges.

HANSEN, Circuit Judge.

James Herman O'Hagan appeals his convictions of all counts in a 57-count indictment for mail fraud, securities fraud, and money laundering. The government cross-appeals, contending that the district court erroneously calculated O'Hagan's sentence. Although O'Hagan raises a whole host of issues, we find merit in two particular claims. First, neither the statutory language of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), nor Supreme Court precedent interpreting it, will support the use of the "misappropriation theory," the theory which formed the basis for O'Hagan's § 10(b) securities fraud convictions. Second, the Securities and Exchange Commission (SEC) exceeded its rulemaking

authority under section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(e), when it promulgated Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a), and omitted therefrom the requirement that a breach of a fiduciary duty must be shown in order to violate the rule. The mail fraud counts are structured in the indictment to hinge on the validity of the securities fraud counts, and the money laundering counts in turn are dependent upon the mail fraud or securities fraud counts. Accordingly, we vacate all of O'Hagan's convictions. The government's cross-appeal is dismissed as moot.

I.

James Herman O'Hagan was a partner in the Dorsey & Whitney law firm in Minneapolis, Minnesota. In approximately July of 1988, Grand Met PLC (Grand Met), a large diversified company based in London, England, retained Dorsey & Whitney as local counsel because Grand Met was interested in acquiring the Pillsbury Company (Pillsbury), a Minneapolis, Minnesota, company. Throughout the remainder of the summer and into the fall of 1988, Grand Met maintained a continued interest in acquiring Pillsbury, but before moving forward with an actual tender offer, it first had to sell a subsidiary company in order to have sufficient capital to finance the purchase of Pillsbury.

On August 18, 1988, O'Hagan began purchasing call options for Pillsbury stock that had a September 17, 1988, expiration date.[1] He subsequently purchased

[1] A call option gives the holder the right to purchase a specified number of shares of stock by a certain date at a specific price. If the shares are not purchased by that date, the option expires and along with it the right to purchase the specified number of shares. For instance, on August 18, 1988, O'Hagan purchased 100 Pillsbury call options. Each call option gave him the right to purchase 100 shares of Pillsbury stock. Each call option also expired on September 17, 1988, if the option was not exercised.

call options that had October 22, 1988, and November 19, 1988, expiration dates. By the end of September 1988, O'Hagan had amassed 2,500 Pillsbury call option contracts.[2] He also held approximately 5000 shares of Pillsbury common stock which he had purchased on September 10, 1988.

On October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock. Pillsbury stock immediately rose from $39 per share to almost $60 per share.[3] Shortly thereafter, O'Hagan exercised his options, purchasing the Pillsbury stock at the lower option price, and then liquidating the stock, along with the previously purchased 5000 shares of common stock, for the higher market price generated by the tender offer. He realized a profit of over $4,000,000 from these securities transactions.

The Securities and Exchange Commission (SEC) subsequently commenced an investigation of O'Hagan and others who had heavily invested in Pillsbury securities shortly before its takeover by Grand Met. This investigation, which was later joined by other

[2] O'Hagan purchased 3,000 Pillsbury call option contracts during August and September 1988. At the end of September of 1988, he held only 2,500 of those contracts because 500 contracts had a September 17, 1988, expiration date.

[3] "When a tender offer is announced, usually the price of the target company rises and the price of the offeror falls or remains the same." *SEC v. Maio*, 51 F.3d 623, 628 n.3 (7th Cir. 1995).

federal law enforcement authorities, culminated with O'Hagan being charged in the instant 57-count indictment. Counts 1-20 charged him with mail fraud in violation of 18 U.S.C. § 1341. Counts 21-37 charged him with securities fraud in violation of § 10(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Counts 38-54 charged O'Hagan with securities fraud in violation of § 14(e) and Rule 14e-3, 17 C.F.R. § 240.14e-3(a), promulgated thereunder. Counts 55-57 alleged various violations of the federal money laundering statutes, 18 U.S.C. §§ 1956(a)(1)(B)(i) and 1957.

The case proceeded to trial, and a jury convicted O'Hagan on all 57 counts. The district court sentenced O'Hagan to 41 months of imprisonment. O'Hagan appeals.

II.

Because we resolve the issues in this case solely on legal grounds, our standard of review is de novo. *United States v. Hang*, 75 F.3d 1275, 1279 (8th Cir. 1996).

A.

O'Hagan challenges his § 10(b) securities fraud convictions, arguing that the theory of liability under which the government prosecuted him, known as the "misappropriation theory," is, as a matter of law, an impermissible basis upon which to impose § 10(b) liability. Before outlining the misappropriation theory, however, we first turn to the language of § 10(b) and its SEC-created counterpart, Rule 10b-5.

Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). The touchstones of § 10(b) liability then, are "manipulation" and "deception" "in connection with the purchase or sale of any security." *Id.* Our focus in this case is on the deception element of § 10(b).[4]

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[4] The other prong of § 10(b) liability, "manipulation" is " 'virtually a term of art when used in connection with securities markets' " referring to practices "such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)). The government does not contend, and the record does not show, that O'Hagan's conduct constituted any of these prohibited acts. In any event, the misappropriation theory thus far has been used only as a vehicle to prosecute acts that constitute deception under § 10(b) and that was the government's approach in this case.

Acting pursuant to the authority granted to it under § 10(b), the SEC promulgated Rule 10b-5, which provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) [t]o employ any device, scheme, or artifice to defraud, [or]
>
> . . .
>
> (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. The SEC thus enacted Rule 10b-5 to include a prohibition on "fraud" as a means of defining the scope of conduct proscribed by the term deception under § 10(b). Significantly, however, fraud under Rule 10b-5 cannot be construed more broadly than its statutory enabler, deception; in other words, Rule 10b-5 fraud cannot prohibit conduct that does not amount to § 10(b) deception. *See Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1446 (1994) ("We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute."); *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977) ("in deciding whether [challenged conduct constitutes] 'fraud' under Rule 10b-5, 'we turn first to the language of § 10(b),'") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)). Thus, although § 10(b) has been described as a broad catchall provision, the fraud that must be caught must also constitute deception within the meaning of the statute. *United States v. Chiarella* 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.").

In construing the scope of conduct that may be regulated under § 10(b), the Supreme Court has definitively ruled that the text of the statute is dispositive. *See Central Bank*, 114 S. Ct. at 1446 ("With respect . . . to . . . the scope of conduct prohibited by § 10(b), the text of the statute controls our decision."); *see also Chiarella*, 445 U.S. at 234 ("As we have emphasized before, the 1934 Act cannot be read '"more broadly than its language and the statutory scheme reasonably permit."'" (citation omitted)). This point could not have been made in clearer terms than in *Central Bank*, the Court's most recent exposition of the reach of § 10(b). There, concluding that a § 10(b) aiding and abetting cause of action was not viable, the Court stated:

> We reach the uncontroversial conclusion, accepted even by those courts recognizing a § 10(b) aiding and abetting cause of action, that the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation. Unlike those courts, however, we think that conclusion resolves the case. It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text.
>
> . . .
>
> Because this case concerns the conduct prohibited by § 10(b), the statute itself resolves the case. . . .

Central Bank, 114 S. Ct. at 1448. This is because "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Santa Fe*, 430 U.S. at 473. In sum, in determining whether conduct falls within § 10(b) deception and Rule 10b-5 fraud, we are confined to what the term deception under § 10(b) will reasonably bear. *See United States v. Bryan*, 58 F.3d 933, 945 (4th Cir. 1995) ("For at least two decades, however, the Supreme Court has repeatedly warned against expanding the concept of fraud in the securities context beyond what the words of the Act will reasonably bear."). It is against this backdrop that we now turn to the two theories of liability which have been created under § 10(b)'s proscription of deception.

The first theory is what has been termed the "classical theory." *See SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990). It was outlined by the Supreme Court in the germinal case of *Chiarella*, 445 U.S. at 226-35, and later refined in *Dirks v. SEC*, 463 U.S. 646, 653-667 (1983). "Under the classical theory, a person violates [Rule 10b-5] when he or she buys or sells securities on the basis of material, non-public information and at the same time is an insider of the corporation whose securities are traded." *SEC v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992). The gravamen of the classical theory is that the "insider owes a fiduciary duty to the corporation's shareholders not to trade on inside information for his personal benefit." *Id.* at 409. In sum, the classical theory deals with corporate "insiders," *i.e.*, those who owe a fiduciary obligation to the shareholders of the corporation whose shares are traded. This theory, however, does not reach those

individuals who trade securities based on material, nonpublic information and who owe no fiduciary duty to the shareholders of the company whose securities are traded; these persons are the so-called "outsiders." *See Clark*, 915 F.2d at 443.

The misappropriation theory addresses those not within the reach of the classical theory. Specifically, it:

> extends the reach of Rule 10b-5 to outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade. [It] focuses not on the insider's fiduciary duty to the issuing company or its shareholders but on whether the insider breached a fiduciary duty to any lawful possessor of material non-public information.

Cherif, 933 F.2d at 409. The misappropriation theory has been held to impose § 10(b) and Rule 10b-5 liability for fraud on an individual who "'(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.'" *Bryan*, 58 F.3d at 944 (quoting *Clark*, 915 F.2d at 443). Under the misappropriation theory, the requirement that the information be used "in connection with the purchase and sale of any security" is satisfied simply because the misappropriated information is used in a subsequent securities transaction. *See id.* at 944-45. The misappropriation theory thus focuses on whether the securities trader breached a fiduciary obligation to the party from whom the material nonpublic information was obtained, notwithstanding whether that

party had any connection to, or even an interest in, the securities transaction, and also without concern as to whether a party who did care about the securities transaction was defrauded. *Id.*

In this case, the government proceeded against O'Hagan on the § 10(b) and Rule 10b-5 counts under the misappropriation theory, although the theory has never been recognized in this circuit. The government contended that O'Hagan breached a fiduciary duty to Dorsey & Whitney and Grand Met when, through his employment at Dorsey & Whitney, he obtained confidential, material, and nonpublic information concerning Grand Met's interest in acquiring Pillsbury, and subsequently used that information as a basis for trading in Pillsbury securities.[5] O'Hagan contends that the misappropriation theory is an impermissible basis upon which to impose § 10(b) liability. Specifically, he argues that the theory cannot be squared with either the plain text of § 10(b) or the

[5] The government did not prosecute O'Hagan under the classical theory, nor could it, because O'Hagan was not an "insider" of Pillsbury, the corporation in whose shares he traded. The government conceded before the magistrate judge that O'Hagan could not be prosecuted under Rule 10(b)-5 for failure to disclose the inside information to Pillsbury stockholders because he had no preexisting fiduciary duty to them and had done nothing to induce the officers and directors of Pillsbury to place their trust or confidence in him. Report and Recommendation of Magistrate Judge Cudd (Sept. 10, 1993), App. at 672-73. The magistrate judge's report and recommendation, adopted by the district court, concluded that "[a]s far as Pillsbury stockholders were concerned, Defendant was free under *Chiarella* and *Dirks* to use the alleged inside information as he saw fit." *Id.* at 673. Thus, our attention is focused solely on the misappropriation theory.

Supreme Court's teachings regarding the scope of conduct that may be regulated under that statute.

Neither the Supreme Court nor this court has yet determined whether the misappropriation theory is a permissible basis upon which to impose § 10(b) liability.[6] After carefully studying the Supreme Court's teachings on the scope of conduct reachable under § 10(b), however, coupled with the recent *Central Bank* ruling that the plain text of the statute controls this issue, we hold that § 10(b) liability cannot be based on the misappropriation theory. We reach this conclusion because, contrary to § 10(b)'s explicit requirements, the misappropriation theory does not require "deception," and, even assuming that it does, it renders nugatory the requirement that the "deception" be "in connection with the purchase or sale of any security."

We first turn our attention to the meaning ascribed to § 10(b) by the Supreme Court. That Court has repeatedly held that the deception prohibited under § 10(b) consists of the making of a material misrepresentation or the nondisclosure of material informa-

[6] In *Carpenter v. United States*, 484 U.S. 19, 24 (1987), an evenly divided Court affirmed a § 10(b) criminal conviction premised on the misappropriation theory, without expressing any views on the validity of the theory. Further, in *Chiarella*, 445 U.S. at 235-36, the Court declined to consider the government's argument that the misappropriation theory was a permissible basis upon which to affirm the defendant's § 10(b) conviction because such a theory had not been submitted to the jury.

With respect to this court, as far as we can tell, this is the only case in which the misappropriation theory of § 10(b) liability has been presented to us.

tion, in violation of a duty to disclose. *See, e.g., Central Bank*, 114 S. Ct. at 1446-48; *Santa Fe*, 430 U.S. at 470, 476. The *Santa Fe* Court, in fact, explicitly rejected the lower court's reading of § 10(b) which required no misrepresentation or nondisclosure. *Santa Fe*, 430 U.S. at 470-76. The *Central Bank* Court confirmed that misrepresentation or nondisclosure are requirements for § 10(b) liability. *See Central Bank*, 114 S. Ct. at 1448 ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.").

Additionally, the Court has left no doubt that § 10(b) deception cannot be premised on the mere breach of a fiduciary duty, without an accompanying misrepresentation or lack of disclosure. *See id.* at 1446 ("deception" under § 10(b) does not encompass " 'breaches of fiduciary duty . . . without any charge of misrepresentation or lack of disclosure.' " (quoting *Santa Fe*, 430 U.S. at 470)). *See also Santa Fe*, 430 U.S. at 472 (to interpret "fraud" under Rule 10b-5 to extend to all breaches of fiduciary duty that are linked to a securities transaction would "add a gloss to the operative language of the statute quite different from its commonly accepted meaning.") (internal quotations omitted); *Dirks*, 463 U.S. at 654 ("Not all breaches of fiduciary duty in connection with a securities transaction . . . come within the ambit of Rule 10b-5. There must also be manipulation or deception.") (internal quotations omitted).

We reject the misappropriation theory, in part, because it permits the imposition of § 10(b) liability based upon the mere breach of a fiduciary duty

without a particularized showing of misrepresentation or nondisclosure. As previously stated, the misappropriation theory bases liability upon the mere misappropriation of material nonpublic information in breach of a fiduciary obligation and subsequent use of that information in a securities transaction. *Clark*, 915 F.2d at 443. By its very definition then, it does not require either a material misrepresentation or nondisclosure. Thus, the misappropriation theory runs counter to the *Santa Fe* and *Central Bank* holdings that the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b). *See Bryan*, 58 F.3d at 949 (breach of fiduciary obligation without misrepresentation or nondisclosure does not constitute deception and thus conflicts with *Central Bank* and *Santa Fe*).

We need not tarry long on this point, however, because the misappropriation theory fails on another, more obvious, basis. The language of § 10(b) requires that the fraud be "in connection with the purchase or sale of any security." The misappropriation theory, however, permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the "in connection with . . ." statutory language. As noted by the Fourth Circuit, "The [Supreme] Court has left no doubt that the principal concern of section 10(b) is the protection of purchasers and sellers of securities." *Bryan*, 58 F.3d at 946-47. We agree. A careful reading of the Supreme Court's decisions in *Chiarella*, *Dirks*, and *Central Bank* reveals that only a breach of a duty to parties to the securities transaction or, at the most, to other

market participants such as investors, will be sufficient to give rise to § 10(b) liability.

This principle was explicitly stated in *Chiarella*. There, relying upon common law fiduciary principles, the Court held that one commits Rule 10b-5 fraud by failing to disclose material non public information in violation of a duty to disclose. *Chiarella*, 445 U.S. at 228. This duty to disclose, however, arises only "from a relationship of trust and confidence *between parties to a transaction*." *Id.* at 230 (emphasis added). The Court reiterated this point later in the opinion, stating that liability could be founded only on the breach of a fiduciary duty by "a person in whom the sellers had placed their trust and confidence." *Id.* at 232.

The *Dirks* Court reaffirmed this principle, stating "that '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.'" *Dirks*, 463 U.S. at 657-58 (quoting *Chiarella*, 445 U.S. at 232-33). Although the Court referred only to "parties," rather than "parties to a transaction," as in *Chiarella*, the Court gave no indication that it intended to retreat from *Chiarella*'s holding. To the contrary, the *Dirks* Court stated early in its opinion that the duty to disclose crafted in *Chiarella* was applicable only to the corporation whose securities were being traded. *See id.* at 654 ("We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'" (quoting *Chiarella*, 445 U.S. at 232)). The Court did indicate, however, that if § 10(b) was to be construed to reach beyond parties to the securities transaction, at the very most it extended to market participants, namely investors. *See id.* at 664 n.23 ("a violation [of § 10(b)] may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors.'" (quoting *Ernst & Ernst*, 425 U.S. at 199)).

Finally, the *Central Bank* Court clearly placed the focus of § 10(b) on purchasers and sellers of securities: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which *a purchaser or seller of securities* relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." 114 S. Ct. at 1455 (emphasis added). The Court also reaffirmed the principle it had set forth in *Dirks* that, if construed to reach beyond the purchasers and sellers to a securities transactions, § 10(b) at the very broadest can be read to reach only market participants. *See id.* at 1446 (stating that "the broad congressional purposes behind the [Securities] Act" is "to protect investors from false and misleading practices that might injure them."). *See also Bryan*, 58 F.3d at 948, 950 (if construed to reach beyond purchasers and sellers of securities, outer boundary of § 10(b) reaches no further than other market participants).

Against this venerable body of law, the misappropriation theory, which allows the imposition of § 10(b) liability even though no market participant was deceived or defrauded, cannot be defended. By evading the statutorily required nexus that the fraud

be "in connection with the purchase or sale of any security," the misappropriation theory essentially turns § 10(b) on its head, "transforming it from a rule intended to govern and protect relations among market participants" into an expansive "general fraud-on-the-source theory" which seemingly would apply to an infinite number of trust relationships. *Bryan*, 58 F.3d at 950; *see also id.* at 951 (observing that courts have applied the misappropriation theory to a wide variety of trust relationships and if taken to its logical conclusion would apply to case of simple theft by an employee). Such a wide ranging application of § 10(b) liability simply cannot be reconciled with the *Central Bank* holding that the text of § 10(b) governs the scope of conduct which may be regulated under that provision, coupled with the focus in *Chiarella*, *Dirks*, and *Central Bank* on parties to the securities transaction or, at most, other market participants. *See also id.* at 950 (the misappropriation theory "artificially divides into two discrete requirements—a fiduciary breach and a purchase or sale of securities—the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction.").

The government contends that "[t]he in connection with element is met whenever a fraud touches the purchase or sale of a security, a standard which has been described as being very tenuous indeed." Gov. Br. at 48 n.37 (inner quotations omitted). This "touch" test stems from a passage in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), where the court stated, "The crux of the present case is that [the victim] suffered an injury as

a result of deceptive practices *touching* its sale of securities as an investor." (emphasis added). According to the government, the Court's use of "touch" demonstrates that the fraud need not be upon a party interested in a securities transaction.

We decline to ascribe such broad meaning to this single passage from *Bankers Life*. Such a sweeping interpretation appears to be inconsistent with the Court's statement in the immediately previous paragraph of *Bankers Life* that "we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances *in the purchase or sale of securities*." *Bankers Life*, 404 U.S. at 12 (emphasis added). More importantly, the victim of the fraud in *Bankers Life* was a seller of securities who was "injured as an investor." *Id.* at 10; *see also Bryan*, 58 F.3d at 950 n.17 (same). Finally, if this passage held the all-encompassing meaning the government attributes to it, then we cannot fathom how the defendants in the subsequent *Chiarella*, *Dirks*, and recently *Central Bank* cases escaped § 10(b) liability because each engaged in acts that "touched" the securities transaction.[7]

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[7] The government pointed out in oral argument that we have cited *Bankers Life* and employed its "touch" in several cases. *See Harris v. Union Elec. Co.*, 787 F.2d 355, 368 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986); *United States v. Gruenberg*, 989 F.2d 971, 976 (8th Cir.) (quoting *Harris*), *cert. denied*, 114 S. Ct. 204 (1993). From this, the government contends that we have held that only a tenuous connection need be established between the fraud and the securities transaction, and applying that reasoning to this case, we must uphold O'Hagan's § 10(b) convictions. We have not held, however, nor could we in the face of the Supreme Court authority cited above, that the person defrauded need not be an individual who

Several of our sister circuits have concluded that § 10(b) liability may be predicated on the misappropriation theory, while the Fourth Circuit recently reached the opposite conclusion, rejecting outright the misappropriation theory as a basis for imposing § 10(b) liability. *See Bryan*, 58 F.3d at 933. We find the analysis from *Bryan* persuasive and have borrowed heavily from it in arriving at our conclusion. Therefore, we adopt that court's analysis in its entirety as our own.[8]

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has an interest or stake in a securities transaction. We simply held in these cases that the "touch" test is easily satisfied as long as the party defrauded is a market participant.

[8] *Bryan* was decided after the briefing had been completed in this case but prior to oral argument. The parties addressed the applicability of *Bryan* at oral argument. The government contends that *Bryan* holds that when information is misappropriated from a nonmarket participant, no fraud occurs under § 10(b); conversely when information is misappropriated from a market participant, fraud for the purposes of § 10(b) has occurred. In making this argument, the government contends that *Bryan* did not really depart from the holdings of other circuits and that no split in the circuits is present. We decline to read *Bryan* in the narrow fashion urged by the government. The *Bryan* court's holding rejected the misappropriation theory in sweeping terms. *See Bryan*, 58 F.3d at 944 ("We conclude that neither the language of section 10(b), Rule 10b-5, the Supreme Court authority interpreting these provisions, nor the purposes of these securities fraud provisions, will support convictions resting on the particular theory of misappropriation adopted by our sister circuits."). It did not, contrary to the government's contention, make a distinction between market v. nonmarket participants. In fact, had it done so, there would have been no need to explicitly disagree with the holdings from other courts which have adopted the misappropriation theory because the overwhelming majority of those cases has involved market participants.

We have read with care the cases in which our sister circuits, namely the Second,[9] the Seventh,[10] the Ninth,[11] and, arguably, the Third,[12] have adopted the misappropriation theory. With all due respect to these courts, for the most part, they seem to adopt the misappropriation theory without conducting a rigorous analysis of the text of § 10(b) and Supreme Court precedent. The genesis of the misappropriation theory, the Second Circuit's holding in *United States v. Newman*, 664 F.2d 12, 16-19 (2d Cir. 1981) (subsequent case history omitted), is emblematic. There, the court held that "deceitful misappropriation of confidential information by a fiduciary" was fraudulent under Rule 10b-5 and was "in connection with the purchase or sale of any security" because his "sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies." *Id.* at 18. However,

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[9] *See, e.g., United States v. Libera*, 989 F.2d 596, 599-600 (2d Cir.), *cert. denied sub nom. Sablone v. United States*, 114 S. Ct. 467 (1993); *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992); *United States v. Newman*, 664 F.2d 12, 16-19 (2d Cir. 1981) (subsequent case history omitted).

[10] *See Sec v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *Cherif*, 933 F.2d at 410.

[11] *See SEC v. Clark*, 915 F.2d at 453.

[12] *See Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985), *rev'd after remand*, 808 F.2d 252 (1986), *cert. denied*, 481 U.S. 1017 (1987). Courts that have discussed the misappropriation theory posit that the Third Circuit embraced it in *Rothberg*. We believe this is fairly debatable however, because the court devoted a mere paragraph to the principles underlying the theory, coupled with a citation to *Newman*. *Id.* at 822. In any event, we will assume for the purposes of this case that the *Rothberg* court adopted the theory.

the *Newman* court did not quote or discuss the language of § 10(b), did not cite *Santa Fe*, and only mentioned in passing the majority opinion in *Chiarella*. The court validated the misappropriation theory on the language of Rule 10b-5, Chief Justice Burger's dissent in *Chiarella*, and other areas of law in which the misappropriation of property has been held to be criminal. We take pause to note that the language of § 10(b), not Rule 10b-5, determines the scope of conduct the statute reaches. Additionally, Chief Justice Burger's position in *Chiarella* was espoused in a dissent and not the majority opinion.[13] Finally, the *Santa Fe* Court made clear that in construing § 10(b) resort could not be had to analogous federal statutes. *See Santa Fe*, 430 U.S. at 471-72 (court of appeals erred in relying on definition of fraud from other contexts in defining term in § 10(b) context); *see also Carpenter*, 484 U.S. at 24 (unanimously affirming defendant's mail fraud and wire fraud convictions based on same facts which divided the Court on § 10(b) conviction based on misappropriation theory).

Other courts that have recognized the misappropriation theory have either relied heavily on *Newman* or utilized interpretational methods which conflict with the Supreme Court's teachings on interpreting the scope of conduct encompassed by § 10(b). *See Rothberg*, 771 F.2d at 822 (relying solely on *Newman*); *Cherif*, 933 F.2d at 410 n.5 (relying on *Newman* and stating "[t]he more precise issues of statutory construction and legislative history have

[13] As we noted above, the *Chiarella* Court declined to address whether a misappropriation theory was valid because such a basis was not submitted to the jury.

been treated exhaustively elsewhere, and we decline to revisit them."); *Clark*, 915 F.2d at 443-53 (relying in part on *Newman* and also utilizing the meaning of fraud in other contexts). We note that neither *Cherif* nor *Clark* acknowledge *Santa Fe* in conducting their analysis. In essence, the courts which recognize the misappropriation theory seem to have validated it on the basis of the assumed unfairness of allowing an individual to trade securities on the basis of information which is not available to other traders. *See United States v. Carpenter*, 791 F.2d 1024, 1029 (2d Cir. 1986) (misappropriation theory permissible to give "legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair. . . .") (citation and quotations omitted), *aff'd in part by evenly divided Court and rev'd in part*, 484 U.S. 19, 24 (1987). However, the Supreme Court has repeatedly held that the mere possession of material nonpublic information does not automatically create a duty to disclose. *See Chiarella*, 445 U.S. at 232 ("not every instance of financial unfairness constitutes fraudulent activity under § 10(b)"); *id.* at 235 ("We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."); *Dirks*, 463 U.S. at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."). The *Bryan* court undertook an exhaustive review of the opinions from these courts and concluded that these courts simply had given insufficient weight to the text of § 10(b) and improperly construed

the Supreme Court's pronouncements on the reach of that provision. We agree fully with that observation and, therefore, we respectfully decline to follow the holdings of our sister circuits which have adopted the misappropriation theory.

As the Supreme Court has said, the securities industry generally, and § 10(b) specifically, is "'an area that demands certainty and predictability'" and "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business'" are to be avoided. *Central Bank*, 114 S. Ct. at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). The misappropriation theory undermines this interest by permitting liability to be imposed in a wide variety of circumstances involving a breach of fiduciary duty, presumably including a simple employee theft. *See Bryan*, 58 F.3d at 951-52 (outlining myriad of fiduciary situations in which the misappropriation theory has been applied). In essence, the theory creates "'a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5.'" *Central Bank*, 114 S. Ct. at 1454 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975)). *See also Blue Chip Stamps*, 421 U.S. at 737 (Court described burgeoning of liability in § 10(b) area as "a judicial oak which has grown from little more than a legislative acorn."); *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (en banc) (Winter, J., concurring in part and dissenting in part) (describing liability under § 10(b) for insider trading and stating that "caselaw establishes that some trading on material nonpublic information is illegal and some is not. The line between

the two is less than clear."), *cert. denied*, 503 U.S. 1004 (1992).[14] In this light, we think the misappropriation theory cannot be countenanced.[15]

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[14] Perhaps the paradigmatic example of the attenuated circumstances in which a § 10(b) conviction based on the misappropriation theory has been obtained is *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y.), *appeal dismissed*, 778 F. Supp. 205 (S.D.N.Y. 1991). There, the government charged that the defendant, a psychiatrist, breached a physician-patient duty of confidentiality when he traded securities based on material, nonpublic information supplied by a patient that her husband was interested in becoming the CEO of BankAmerica. 737 F. Supp. at 270-72. In sustaining the defendant's conviction, the court held that under the misappropriation theory, § 10(b) liability was not limited only to situations in which the breach of the fiduciary relationship implicates the securities markets. 778 F. Supp. at 208-09.

[15] The misappropriation theory has also been criticized by commentators, primarily for the very reasons we reject the theory today. *See* Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 Alb. L. Rev. 139 (1995); David C. Bayne, *The Insider's Natural Law Duty: Chestman and the "Misappropriation Theory"*, 43 U. Kan. L. Rev. 79 (1994). *See also* John R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. Pa. L. Rev. 1077, 1138 (1996). The Beeson article gives a perfect example of the ad-hoc basis on which the theory is employed, offering by way of example two individuals who obtain material, nonpublic information, on which they subsequently trade securities. One can be prosecuted under § 10(b) while the other cannot, based simply on the fact that the individual who may be prosecuted traded on the information in violation of a breach of a fiduciary duty while the other individual received the information fortuitously. *See* Beeson, 144 U. Pa. L. Rev. at 1078-79. These two individuals call to mind the Supreme Court's statement in *Chiarella* that "a duty to disclose under § 10(b) does not arise

Accordingly, we hold that the misappropriation theory is not a valid basis upon which to impose criminal liability under § 10(b). Thus, because O'Hagan's convictions for securities fraud under § 10(b) and Rule 10b-5 in Counts 21-37 were premised solely on the misappropriation theory, these convictions must be vacated.

B.

O'Hagan also challenges his securities fraud convictions under § 14(e) of the Securities Exchange Act and Rule 14e-3. Section 14(e) provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer. . . . The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e). The first sentence in § 14(e) was enacted in 1968 as part of the Williams Act. *Chestman*, 947 F.2d at 564. "'The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information.'" *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985) (quoting *Rondeau v. Mosinee*

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from the mere possession of nonpublic market information." 445 U.S. at 235.

Paper Corp., 422 U.S. 49, 58 (1975)). *See also Piper v. Chris-Craft Indus.*, 430 U.S. 1, 35 (1977) ("The legislative history thus shows that the sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer."). Thus, the focus of § 14(e) is on the shareholders of the company who are or will be confronted with a tender offer. The purpose of § 14(e) is to "add[] a broad antifraud prohibition modeled on the antifraud provisions of § 10(b) of [the Securities Exchange Act of 1934] and Rule 10b-5. . . ." *Schreiber*, 472 U.S. at 10 (inner quotations and citations omitted).

The second sentence of § 14(e) is a rulemaking provision that was enacted in 1970, two years after the original Williams act. *Chestman*, 947 F.2d at 564. Accordingly, the SEC promulgated Rule 14e-3(a) in 1980, which provides:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the [Securities Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
>
> (1) The offering person,
>
> (2) The issuer of the securities sought or to be sought by such tender offer, or

> (3) Any officer, director, partner, or employee or any other person acting on behalf of the offering person or such issuer,
>
> to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its sources are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a).

"Rule 14e-3(a) is a disclosure provision." *Chestman*, 947 F.2d at 557. An individual violates the rule when "he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired 'directly or indirectly' from an insider of the offeror or issuer, or someone working on their behalf." *Id.* (quoting Rule 14e-3(a)). Thus, the rule creates a duty to disclose this information, or to abstain from trading, "regardless of whether such information was obtained through a breach of fiduciary duty." *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *see also SEC v. Peters*, 978 F.2d 1162, 1166-67 (10th Cir. 1992) (holding breach of fiduciary relationship not required to establish violation of Rule 14e-3); *Chestman*, 947 F.2d at 557 (Rule 14e-3(a) "creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information.").

O'Hagan contends that his securities fraud convictions under § 14(e) and Rule 14e-3(a) must be vacated because the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3(a). Specifically, O'Hagan claims that the SEC impermissibly redefined fraud in Rule 14e-3(a) by omitting the requirement that a breach of a fiduciary duty must be shown because the term fraud under § 14(e) requires a breach of fiduciary duty.

An administrative rule exceeds its statutory mandate if it is "inconsistent with the statutory mandate or . . . frustrate[s] the policy that Congress sought to implement." *Securities Indus. A'ssn v. Board of Governors*, 468 U.S. 137, 143 (1984) (inner quotations and citation omitted). To date, three courts have considered whether the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3 without the requirement of a breach of a fiduciary duty. *See Maio*, 51 F.3d at 634-35; *Peters*, 978 F.2d at 1165-67; *Chestman*, 947 F.2d at 556-63. These courts have all concluded that the SEC did not exceed its authority. After carefully reviewing these decisions and considering them in light of the text of § 14(e) and the Supreme Court's holdings in *Chiarella* and *Schreiber*, we conclude that we must depart from the holdings of our sister circuits and hold that the SEC exceeded its rulemaking authority by enacting Rule 14e-3(a) without including the requirement of a breach of a fiduciary duty.

Because this issue turns on the scope of conduct that may be regulated by § 14(e), once again the plain language of the statute is controlling. *See Central Bank*, 114 S. Ct. at 1446-48 (with respect to determining the scope of conduct prohibited by § 10(b), "the

text of the statute controls our decision"). Although the *Central Bank* Court dealt with scope of conduct prohibited by § 10(b), the Court stated unequivocally that its textual analysis applied to all provisions in the Securities Act. *See id.* at 1447 ("Adherence to the text in defining the conduct covered by § 10(b) is consistent with our decisions interpreting other provisions of the securities Acts."). This methodology is in line with that employed by the *Schreiber* Court where, in the context of interpreting the term "manipulative" under § 14(e), the Court turned to the language of the statute. *See* 472 U.S. at 6 ("[t]he starting point is the language of the statute.").

We thus turn our attention to the text of § 14(e). Specifically, we focus on the second sentence of that provision, the enabling provision. It provides in pertinent part: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent. . . ." Eliminating those words having no bearing to our inquiry, the statute empowers the SEC to "define" and "prescribe means reasonably designed to prevent" "acts and practices" which are "fraudulent." Thus, by dissecting the language and structure of the statute, it becomes clear that the terms "define" and "prescribe" relate to "acts and practices" meeting the statutory definition of "fraudulent."

A straightforward exercise in statutory construction then affords no basis for concluding that § 14(e) authorizes the SEC to create its own definition of fraud in implementing the statute. Simply put, the enabling provision of § 14(e) permits the SEC to identify and regulate those "acts and practices"

which fall within the § 14(e) legal definition of "fraudulent," but it does not grant the SEC a license to redefine the term. *See Chestman*, 947 F.2d at 584 (Mahoney, J., concurring in part and dissenting in part) ("the plain meaning of the dispositive language is that the SEC is empowered to identify and regulate, in this (then) novel [tender offer] context, the 'acts and practices' that fit within the existing legal categories of the 'fraudulent, deceptive, or manipulative,' but not to redefine the categories themselves.").

The government takes issue with this reading of § 14(e), claiming that the plain language is a broad delegation to the SEC of rulemaking powers and, when properly read, it empowers the SEC to "define" and "prescribe means reasonably designed to prevent" "fraudulent conduct" in the tender offer context. In essence, the government conflates the language of the statute into a broad empowerment to the SEC to "define" and "prescribe" "fraud." As we point out above, however, this is not what the plain language of § 14(e) delegates to the SEC; the enabling provisions simply permit the SEC to "define" and "prescribe" "acts and practices" which meet § 14(e)'s meaning of "fraudulent."

We thus must ascertain the meaning of "fraudulent" in § 14(e). The Congress gave no indication that the term was to have a meaning different from its common legal definition. *See id.* ("Furthermore, these venerable terms are used in their normal, accepted definitions."). The *Schreiber* Court looked to the common law and dictionary definitions in defining manipulation. *See Schreiber*, 472 U.S. at 7 (court construed "manipulative" in manner consistent with its common law and dictionary defini-

tion). Black's Law Dictionary provides certain definitions of "fraud" which are entirely consistent with the breach of a fiduciary duty, while other definitions would impose no such requirement. *Compare Black's Law Dictionary* 660 (6th ed. 1990) ("concealment of that which should have been disclosed," and "acts, omission, and concealments involving a breach of a legal or equitable duty") *with id.* ("An intentional perversion of truth for the purpose of inducing another in reliance upon it," "A false representation of a matter of fact," and "A generic term, embracing all multifarious means which human ingenuity can devise"). Thus, the dictionary definitions provide little assistance in resolving this problem. However, the analytic model created by the Supreme Court's holdings in *Schreiber* and *Chiarella*, cases drawing heavily on common law principles, leads to the inescapable conclusion that fraudulent under § 14(e) must be read to include a breach of a fiduciary duty.

In *Schreiber*, the Court explicitly held that § 14(e) is modeled after the broad antifraud provisions of § 10(b) and Rule 10b-5. 472 U.S. at 10 & n.10. Moreover, in the course of interpreting manipulation, the Court turned to the meaning that term had been given under § 10(b), noting that "Congress used the phrase 'manipulative or deceptive' in § 10(b) as well, and we have interpreted 'manipulative' in that context to require misrepresentation." *Id.* at 7-8 & n.6. The Court went on to note that "[a]ll three species of misconduct, *i.e.*, 'fraudulent, deceptive, or manipulative,' listed by Congress are directed at failures to disclose." *Id.* at 8. Accordingly, the definition that fraudulent has been given under § 10(b) and Rule 10b-5 guides our interpretation of the term under § 14(e).

As we observed during our discussion of § 10(b), the *Chiarella* Court drew upon common law concepts in defining fraud under § 10(b), holding that the term encompassed a failure to disclose information but only if there was a duty to speak. 445 U.S. at 222, 235. This duty to speak, in turn, arises out of a " 'fiduciary or other similar relation of trust and confidence.' " *Id.* at 228 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

Reading *Schreiber* and *Chiarella* together leads to the conclusion that "fraudulent" under § 14(e) includes the breach of a fiduciary obligation. Initially, we note that § 10(b) and § 14(e) are contained in the same statutory enactment, the Securities Exchange Act of 1934—strong evidence that the terms are to be given the same meaning. *See Gustafson v. Alloyd Co., Inc.*, 115 S. Ct. 1061, 1067 (1995) (term "prospectus" construed to have the same meaning in § 10 of the 1933 Securities Act as in § 12 of that same Act); *see also id.* (in holding that "identical words used in different part of the same act are intended to have same meaning," Court stated "[t]he Securities Act of 1933, like every Act of Congress, should not be read as a series of unrelated provisions."). That § 10(b) does not specifically include the term fraud is of no moment because it is beyond cavil that that provision is a powerful antifraud provision. *Chiarella*, 445 U.S. at 234-35. Further, the *Schreiber* Court turned directly to § 10(b) to define terms in § 14(e), and *Chiarella* held that fraudulent under § 10(b) requires the breach of a fiduciary obligation. Of added import, the *Schreiber* Court held that "fraudulent" under § 14(e) was directed at nondisclosure of information, while the *Chiarella* Court detailed the circumstances

under which nondisclosure is fraudulent under § 10(b). Additionally, we also think it significant that the *Chiarella* Court turned to common law concepts in giving meaning to fraudulent under § 10(b), as did the *Schreiber* Court in interpreting manipulative under § 14(e).

Finally, we also find telling that, in the quote from *Chiarella* in the above paragraph, the Supreme Court quoted the Restatement (Second) of Torts and then stated that the American Law Institute views this rule as applicable to "securities transactions." *See Chiarella*, 445 U.S. at 228 n.9 ("As regards securities transactions, the American Law Institute recognizes that 'silence when there is a duty to . . . speak may be a fraudulent act.'" (quoting ALI, Securities Code § 262(b) (Prop. Off. Draft 1978)). It is inexplicable to us why this Restatement rule, should have definitive force in the § 10(b) context but not in the § 14(e) context, especially in light of the fact that the two sections are part of the same statutory scheme. *See Chestman*, 947 F.2d at 586-87 (Mahoney, J., concurring in part and dissenting in part). Accordingly, we hold that *Schreiber* and *Chiarella* mandate that "fraudulent" under § 14(e) must be interpreted to require the breach of a fiduciary obligation or similar trust relationship.[16]

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[16] Additionally, some commentators have indicated that the rationale from *Bryan*, 58 F.3d at 943-59, with respect to the misappropriation theory under § 10(b), also calls into doubt the validity of Rule 14e-3(a). Richard M. Phillips & Gilbert C. Miller, *Litigation Reform in the Courts: Limiting Section 12(2) Liability, The Bespeaks Caution Doctrine and the Misappropriation Theory*, CA28 ALI-ABA 487, 527 (February 16, 1996) ("Indeed, under the [*Bryan*] court's rationale, it is by no means clear that SEC Rule 14-3 would be upheld to preclude transactions in the securities of target companies by insiders of tender offerors.").

The government does not explicitly address the force of *Chiarella* and *Schreiber* on this issue, instead arguing that if the authority granted to the SEC to define fraud is circumscribed to simply applying the meaning that term is given in the § 10(b) context, the SEC really has no authority at all under the statute. We disagree. As we noted above, the SEC does not have the authority to define fraud; rather, the plain language of § 14(e) permits the SEC to define and prescribe preventive measures for acts and practices which are fraudulent. Moreover, this grant of authority to the SEC, even without the power to define fraud, remains a very powerful tool because the SEC has broad latitude in regulating acts and practices in the wide ranging and diverse field of tender offers. Finally, and most importantly, we think *Schreiber* is a strong rebuttal to this argument because there the Court looked directly at § 10(b) to define manipulative under § 14(e). 472 U.S. at 7-8.

The government also points out that the language in § 14(e), granting the SEC rulemaking authority, is different from that in § 10(b), arguing that the § 14(e) language grants the SEC much broader rulemaking powers than under § 10(b). We believe, however, the government makes too much of what in reality are simply minor discrepancies in language between the two provisions. Section 10(b) permits the Commission to create "rules and regulations" which are "necessary or appropriate in the public interest or for the protection of investors," while § 14(e) empowers the Commission to enact "rules and regulations" which "define" and "prescribe means reasonably de-

signed to prevent" "acts and practices" which are "fraudulent." In the end, although perhaps § 14(e) is the product of clearer legislative draftsmanship, the authority granted to the SEC under both provisions is fundamentally the same. *See Chestman*, 947 F.2d at 587 (Mahoney, J., concurring in part and dissenting in part) (positing that minor discrepancies in statutory language of § 10(b) and § 14(e) are of no significance).[17]

Finally, the government contends that the meaning of "fraudulent" under § 14(e) is irrelevant in deciding this issue because of the statutory language authorizing the SEC "to prescribe means reasonably designed to prevent" the acts and practices which are fraudulent. The government argues that under this language, the SEC may regulate conduct which is not fraudulent in order to prevent the commission of a fraudulent act. The government points to a passage from a footnote in *Schreiber*, where the Court stated that the enabling provision in § 14(e) empowered the

[17] We also note that to the extent that the *Chestman* majority relied on the statements of a subsequent Congress in interpreting § 14(e), such a method of interpretation was condemned by the Supreme Court in *Central Bank*. There, the court made clear that using statements of a later Congress to interpret a statute enacted by an earlier Congress is to be avoided, at least in the area of securities law. *See Central Bank*, 114 S.Ct. at 1452 ("[T]he interpretation given by one Congress (or committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute."). As the government correctly observes, however, the *Chestman* majority first relied on the text of the statute to reach its conclusion, and thus it is unclear how much weight the majority gave to this evidence. *See Chestman*, 947 F.2d at 558.

SEC to "regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts. . . ." 472 U.S. at 11 n.11. However, the government fails to include the remainder of this sentence from *Schreiber*, which states, "without suggesting any change in the meaning of the term 'manipulative' itself." *Id.* Properly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule.

We take pause to observe, as the government points out, that "[b]ecause Congress has expressly granted the SEC authority to promulgate rules which will implement section 14(e), rules promulgated under that section have 'legislative effect' and are 'entitled to more than mere deference. . . .'" (Gov't's Br. at 53 (quoting *Batterton v. Francis*, 432 U.S. 416, 425-26 (1977).) Thus, the government continues, we may not set aside these rules simply because we would have interpreted § 14(e) in a manner different from the SEC, but only if the rule is inconsistent with the statutory mandate or frustrates the Congressional policy sought to be implemented.

While the government's point is well made, nonetheless, an administrative agency's interpretation of a statute under which it has been given rulemaking authority is not wholly beyond reproach. In this vein, the Supreme Court observed in *IBT v. Daniel*, 439 U.S. 551, 566 n.20 (1979), that "[T]his deference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history. On a number of occasions in recent years this Court has found it neces-

sary to reject the SEC's interpretation of various provisions of the Securities Acts." *See also Aaron v. SEC*, 446 U.S. 680, 694 n.11 (1980) (rejecting SEC's view that scienter is not required in § 10(b) injunctive proceedings); *Business Roundtable v. SEC*, 905 F.2d 406, 407 (D.C. Cir. 1990) (holding that SEC exceeded its statutory authority in promulgating Rule 19c-4 to bar national securities exchange and associations from listing stocks violative of one share/one vote principle). We conclude that, in this instance, the SEC has once again acted in excess of its statutory authority.

We hold that the SEC exceeded its rulemaking authority under § 14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation. Accordingly, we must vacate O'Hagan's securities fraud convictions under these provisions.

C.

O'Hagan was also convicted on a number of counts of mail fraud and money laundering. The essential elements of the crime of mail fraud are: (1) a scheme to defraud, or to obtain money or property by false pretenses, and (2) use of the mails to further the scheme. *United States v. Wicker*, 80 F.3d 263, 267 (8th Cir. 1996). The mere fact that O'Hagan's securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed. *See Carpenter*, 484 U.S. at 24 (unanimously affirming mail and wire fraud convictions based on the same facts that evenly divided the Court on the defendant's securities fraud convictions); *Bryan*, 58 F.3d at 936 (affirming mail fraud and wire fraud counts but reversing on securities fraud

counts). However, in the present case, the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud. (*See* R. at 697-706.) Because O'Hagan's conduct did not constitute securities fraud for the reasons we have noted above, there was no fraud upon which to base the mail fraud charges. Accordingly, we reverse O'Hagan's mail fraud convictions.

With regard to the money laundering counts, they were predicated on the securities fraud or mail fraud counts. Because we have vacated all of the securities fraud and mail fraud counts, there no longer remain any convictions to serve as the predicate conduct upon which to base the money laundering counts. We therefore must reverse these convictions as well. *See* 18 U.S.C. §§ 1956-1957 (requiring the property involved in the transaction to be derived from or the proceeds of unlawful activities).

III.

Our ruling today should in no manner be understood as condoning O'Hagan's conduct. From the record, it appears as though O'Hagan, then an attorney at law, engaged in at least some transactions in Pillsbury securities after learning privileged, confidential information that his law firm was representing a client intending a takeover of Pillsbury. Such conduct is certainly unethical and immoral and must be condemned, which we make haste to do. We note that O'Hagan was disbarred in Minnesota, and served a 30-month sentence after being convicted in Minnesota state court for invading clients' trust funds. However, it is a fundamental principle of the criminal law that not every ethical or moral trans-

gression falls within its realm. This case is a prime example of that principle. Accordingly, for the reasons enumerated above, we reverse O'Hagan's securities fraud, mail fraud, and money laundering convictions and remand this case to the district court for dismissal of the indictment.

FAGG, Circuit Judge, dissenting.

My colleagues have carefully analyzed both sides of the relevant legal coins and selected the sides that nullify O'Hagan's convictions. Contrary to their well-reasoned views, I would recognize and adopt the misappropriation theory like the Second, Seventh, Ninth, and Third Circuits, *see ante* at 620 & nn. 9-12, and thus uphold O'Hagan's convictions for securities fraud under § 10(b) and Rule 10b-5. *United States v. Libera*, 989 F.2d 596, 599-600 (2d Cir.), *cert. denied sub nom. Sablone v. United States*, 114 S. Ct. 467 (1993); *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990); *Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985), *rev'd after remand*, 808 F.2d 252 (1986), *cert. denied*, 481 U.S. 1017 (1987). Also, like the Second, Seventh, and Tenth Circuits, *see ante* at 623-24, I would hold the Securities Exchange Commission did not exceed its rulemaking authority when it enacted Rule 14e-3(a) without the requirement of a breach of a fiduciary duty, and thus uphold O'Hagan's securities fraud convictions under § 14(e) and Rule 14e-3(a). *United States v. Chestman*, 947 F.2d 551, 556-63 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992); *Maio*, 51 F.3d at 634-35; *SEC v. Peters*, 978 F.2d 1162, 1165-67 (10th Cir. 1992). Having adopted these views, I find no basis to reverse O'Hagan's convictions for mail fraud and money laundering. *See ante* at 31-32.

Because I would affirm all of O'Hagan's convictions, I would also consider the merits of the government's appeal from O'Hagan's sentences.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Crim. No. 4-92-219

UNITED STATES OF AMERICA, PLAINTIFF

v.

JAMES HERMAN O'HAGAN, DEFENDANT

[Filed: Sept. 10, 1993]

REPORT AND RECOMMENDATION

Defendant was present in court with his counsel, Charles Hawkins. The government was represented by Assistant United States Attorneys Lynn Zentner and Christopher Bebel. Attorneys Jan Struumans, Terrence Fruth and Vincent Louwagie, who all have represented Defendant, testified on his behalf.

Before the Court are Defendant's motion to dismiss the indictment and his supplemental motion to dismiss the indictment. Defendant is charged with misappropriation of material, non-public information concerning the acquisition of The Pillsbury Company by Grand Metropolitan, PLC and subsequently making a series of purchases on the securities markets based on this insider information. The indictment alleges in:

a) Counts 1-20 that Defendant committed mail fraud in violation of 18 U.S.C. § 1341 by receiving through the mail twenty confirmation slips;

b) Counts 21-37 that Defendant committed securities fraud in violation of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78ff(a) and 17 C.F.R. § 240.10b-5, by breaching his duty of trust and confidence owed to Grand Met and the Dorsey & Whitney law firm by misappropriating information concerning Grand Met's tender offer for Pillsbury stock and trading on that information in the securities market;

c) Counts 38-54 that Defendant committed securities fraud in violation of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78n(e) and 78ff(a) and 17 C.F.R. § 240.14e-3(a), by trading in Pillsbury stock after substantial steps were taken by Grand Met in its takeover attempt, while in possession of material, non-public information concerning the tender offer; and

d) Counts 55-57 that Defendant engaged in money laundering in violation of 18 U.S.C. § 1957 (Count 55), and 18 U.S.C. § 1956(a)(1)(B)(i) (Counts 56-57) by the wire transfer of funds derived from mail fraud and fraud in the sale of securities, and by obtaining cashier's checks to replace embezzled funds, which sums involved the proceeds from the mail and securities fraud perpetrated by Defendant, all with the intent to conceal and disguise the proceeds of Defendant's unlawful activity.

Defendant moves to dismiss all Counts, 1-57, of the indictment on the grounds that:

a) The Counts are barred on the grounds of double jeopardy by his civil case, pending in this Court;

b) The Counts violate principles of federalism and the "*Petite* Policy" of *Petite v. United States*, 361 U.S. 529 (1960), which counsels against bringing a federal prosecution following a state prosecution based on substantially the same act or acts unless there is a compelling federal interest;

c) The Counts are the result of prosecutorial vindictiveness;

d) There has been preindictment delay; and

e) The information obtained by Defendant was public and immaterial as a matter of law.

Defendant moves to dismiss Counts 1-20 on the grounds that these Counts fail to state an offense because: 1) the indictment fails to allege that either Dorsey & Whitney or Grand Met were deprived of any property as required by the mail fraud statute, 18 U.S.C. § 1341; and 2) because the confirmation slips Defendant received from his brokers were not mailings in furtherance of the alleged fraud.

Defendant moves to dismiss Counts 21-37 on the grounds that these Counts fail to state an offense because: 1) Section 10(b) of the Securities Exchange Act of 1934 does not criminalize insider trading; and 2) the indictment alleges only a breach of a duty of trust and confidence owed to Grand Met and the Dorsey & Whitney law firm, not a duty owed to Pillsbury shareholders.

Defendant moves to dismiss Counts 21-54 on the grounds that: 1) these Counts are barred by the applicable statute of limitations; and 2) these Counts are multiplicitous and should be consolidated into two or three Counts.

Defendant moves to dismiss Counts 38-54 on the grounds that: 1) the SEC exceeded its rulemaking authority in promulgating Rule 14e-3 under which

Defendant is charged; and 2) these Counts fail to state an offense because they do not allege that Grand Met took substantial steps toward the takeover of Pillsbury.

Defendant moves to dismiss Counts 55-56 for failure to state an offense because neither mail fraud nor securities fraud were defined as "specified unlawful activity" in 1988, pursuant to the money laundering statutes under which Defendant is charged.

BACKGROUND

The indictment charges that Defendant violated federal laws against insider trading, mail fraud and money laundering. It is alleged that Defendant, while a partner at the Dorsey & Whitney law firm, misappropriated material, non-public information concerning the acquisition of The Pillsbury Company by Grand Metropolitan, PLC and subsequently made a series of purchases on the securities markets based on this insider information. Defendant denies these allegations.

At the hearing, Defendant's former attorneys in the SEC civil suit testified concerning essentially two subjects. First, the attorneys testified that they believed Defendant would be indicted perhaps as much as two years earlier than he was indicted. However, they admitted that the government made no such affirmative representations. Second, the attorneys testified that glob[al] settlement negations were conducted, but failed, and that attempts to have the government forego prosecution in light of Defendant's state conviction had not been successful. In this regard, the testimony was that the prosecutor had stated that Defendant had been an attorney, had enjoyed societ[y's] benefits and his crimes were many

and involved millions of dollars. The prosecuting attorney is reported to have noted that, compared to less privileged members of society, who might rob a bank, gain only $500.00 and yet be sentenced to 15 to 20 years in prison, Defendant had little to complain about.

DISCUSSION

DOUBLE JEOPARDY

Defendant argues that all Counts, 1-57, are barred by double jeopardy. Defendant contends his SEC civil case, pending in this Court, bars his criminal prosecution. This Court is not persuaded.[1]

The double jeopardy clause bars further prosecution only if jeopardy attached in the initial proceeding. *See Serfass v. United States*, 420 U.S. 377, 388, 391 (1975). Jeopardy does not attach until a jury is empaneled and sworn or in a non-jury trial, when the court begins to hear evidence. *Id.* at 388 and 391. Neither predicate event has occurred in the instant case as the civil proceedings have been stayed. Defendant's argument that the extent of discovery should cause jeopardy to attach is rejected.

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[1] While Defendant was also prosecuted in state court the separate sovereigns doctrine defeats any claim of double jeopardy in regard to the state prosecution vis-a-vis the federal prosecutions. *See Abbate v. United States*, 359 U.S. 187 (1959); *Rinaldi v. United States*, 434 U.S. 22, 28 (1977). While Defendant raises the possibility that the separate sovereigns doctrine is no longer valid after *Grady v. Corbin*, 110 S.Ct. 2084 (1990), *Grady* has recently been overruled by the United States Supreme Court. *United States v. Dixon*, 1993 WL 224417 (June 28, 1993).

FEDERALISM AND PETITE v. UNITED STATES, 361 U.S. 529 (1960)

Defendant contends that all Counts, 1-57, of the indictment must be dismissed because this prosecution violates the principles of federalism and the *Petite* policy of the Justice Department as set forth in *Petite v. United States*, 361 U.S. 529, 530-31 (1960). The *Petite* policy is a general internal guideline of the Department of Justice that counsels against bringing a federal prosecution following a state prosecution based on substantially the same act or acts unless there is a compelling federal interest. As this "policy" is an internal procedural guideline, it cannot be enforced against the government. *United States v. Woodward*, 927 F.2d 433, 435 (8th Cir.), *cert. denied*, 112 S. Ct. 246 (1991); *United States v. Robinson*, 774 F.2d 261, 275 (8th Cir. 1985).

Defendant's federalism argument is equally flawed. Violation of federal laws and statutes is distinct from violation of state laws. *See United States v. Jacobs*, No. 92-3696 (8th Cir. September 1, 1993) (*per curiam*) ("The fact that the federal government prosecutes a federal crime in federal court that could have or has been prosecuted as a state crime in a state court does not itself violate due process."). Finally, this Court has found that this indictment does not raise double jeopardy concerns.

PROSECUTORIAL VINDICTIVENESS

Defendant contends that all Counts, 1-57, should be dismissed for prosecutorial vindictiveness. Defendant is grasping at straws.

Negotiations were conducted between Defendant's attorney and the prosecuting attorney in an attempt to resolve all of the charges facing Defendant. These

global settlement negotiations were unsuccessful. Subsequently, Defendant changed attorneys and these attorneys met with the prosecuting attorney in an attempt to have the government abandon its prosecution of Defendant, in part because they felt Defendant had been punished enough. The government refused and in response to the attorneys' queries noted that Defendant had been an attorney, had enjoyed societ[y's] benefits and that his crimes were many and involved millions of dollars. The prosecuting attorney went on to note that compared to less privileged members of society, who might rob a bank, gain only $500.00 and yet be sentenced to 15 to 20 years in prison, Defendant had little to complain about. On this thin reed, Defendant bases his argument of vindictive prosecution.

A defendant may demonstrate vindictive prosecution by either: (1) proving through objective evidence that the prosecutor's decision was intended to punish him for the exercise of a legal right; or (2) by relying on a presumption of vindictiveness. *See United States v. Beede*, 974 F.2d 948, 951 (8th Cir. 1992), *cert. denied*, ___ U.S. ___, 113 S. Ct. 1016 (1993). A rebuttable presumption of vindictiveness may arise when a prosecutor increases the number or severity of charges. *See United States v. Punelli*, 892 F.2d 1364, 1371 (8th Cir. 1990). Absent such a presumption, Defendant has the burden of proving vindictiveness. *Id.* at 1372.

As the *Beede* court recognized, prosecutorial vindictiveness is not shown where plea negotiations fail and the prosecutor goes ahead with the prosecution. *See United States v. Beede*, 974 F.2d at 951 (citing *Bordenkircher v. Hayes*, 434 U.S. 357 (1978) and *United States v. Goodwin*, 457 U.S. 368, 382-83

(1982)). Moreover, "'A prosecutor should remain free before trial to exercise the broad discretion entrusted to him to determine the extent of the societal interest in prosecution.'" *Id.* at 952 (citing *United States v. Goodwin*, 457 U.S. 368, 382 (1982)). These principles govern this case.

Defendant attempted to negotiate a global settlement and attempted to persuade the prosecuting attorney to drop the charges against him. Defendant's efforts failed. This Court finds that no prosecutorial vindictiveness is proven by the government going forward with Defendant's prosecution.

When asked why the government would not forego prosecution in light of Defendant's state conviction, the prosecutor explained the societal interest in prosecuting Defendant. This Court finds that the prosecutor's statement shows no improper motive.

Correspondingly, this Court finds that no presumption of vindictiveness has arisen in this case and Defendant has failed to prove that the prosecutor's decision was intended to punish him for the exercise of a legal right. This Court also notes that Defendant has failed to identify the right whose exercise is allegedly being punished (failure to reach a negotiated settlement being insufficient), and has failed to establish that there was an increase in the number of severity of charges after exercise of such right. Alternatively, assuming *arguendo* that a presumption of vindictiveness has been established, this Court finds that the presumption has been successfully rebutted by the government, as the prosecutor properly considered societal interests in prosecution.

DELAY

Defendant contends that all Counts, 1-57, should be dismissed for preindictment delay. Defendant is in error. The only evidence in support of Defendant's argument is the testimony of Defendant's former attorneys in the SEC civil proceeding. These attorneys formulated a belief that Defendant would be indicted in the near future. The government made no representations in this regard.

In *United States v. Purham*, 725 F.2d 450, 453 (8th Cir. 1984) the Eighth Circuit stated that:

> [P]reindictment delay may violate the due process clause. *United States v. Lovasco*, 431 U.S. 783, 789-90 (1977); *United States v. Marion*, 404 U.S. 307, 324 (1971). 'A defendant is entitled to dismissal of an indictment where he [or she] shows *actual* prejudice from an *unreasonable* delay on the part of the government. Where actual prejudice is established, the reasons for the delay are balanced against the prejudice shown by the accused.' *United States v. Taylor*, 603 F.2d 732, 735 (8th Cir.) (citations omitted; emphasis in the original), *cert. denied*, 444 U.S. 982 (1979).

Assuming for the purposes of argument that the delay of more than a year between the date of the crime and the filling of the federal indictment was unreasonable, a careful review of the record convinces us that the district court correctly found that appellant did not demonstrate actual prejudice. Appellant has relied solely on the admittedly 'real possibility of prejudice inherent in any extended delay: that memories will dim, witnesses become inaccessible, and evidence be lost . . .

> [T]hese possibilities are not in themselves enough to demonstrate that [appellant] cannot receive a fair trial and to therefore justify the dismissal of the indictment.' *United States v. Marion*, 404 U.S. at 326; *see United States v. Hendricks*, 661 F.2d 38, 40 (5th Cir. 1981); *United States v. Taylor*, 603 F.2d at 735. (Footnote omitted).

Dismissal may also be appropriate if a defendant can show that the delay was an intentional device used by the government to gain tactical advantage over the accused and caused substantial prejudice to his right to fair trial. *United States v. Jackson*, 714 F.2d 809, 811 (8th Cir. 1983). "The ultimate question in determining whether a deliberate or reckless delay is 'tactical' is whether it is engineered to impair the defendant's ability to mount an effective defense by causing him to lose evidence." *United States v. Dennis*, 625 F.2d 782, 794 (8th Cir. 1980).

Defendant has failed to demonstrate any actual prejudice from the delay in bringing the indictment against him. Similarly, Defendant has failed to show that any delay was tactical. In the absence of actual prejudice, Defendant's motion must fail.

FAILURE TO STATE AN OFFENSE—CHARACTER OF INFORMATION

Defendant contends that all Counts, 1-57, must be dismissed for failure to state an offense because the information obtained by Defendant, concerning Grand Met's tender offer, was public and immaterial as a matter of law. Whether information is material is a question of fact to be decided by the trier of fact. *See TSC Indus. v. Northway*, 426 U.S. 438, 450 (1976); *Berg v. First American Bankshares, Inc.*, 796 F.2d 489, 494-95 (D.C. Cir. 1986); *SEC v. Singer*, 786 F.

Supp. 1158, 1172 (S.D.N.Y. 1992). The materiality and nonpublic nature of the information Defendant obtained are elements of the government's case-in-chief which must be proven at trial. On this record, this Court finds that ultimate resolution of these issues must be left to the trier of fact.[2]

FAILURE TO STATE AN OFFENSE—MAIL FRAUD

Defendant contends that the mail fraud counts, 1 through 20, must be dismissed because they fail to allege that he obtained money or property from Grand Met or Dorsey & Whitney, an essential element of the crime. Defendant's motion appears to raise two issues: first, whether the counts allege that Defendant obtained property from Grand Met and Dorsey & Whitney, and second, whether the property allegedly obtained is property as that term is used in 18 U.S.C. § 1341.

We turn to the allegations of the indictment. Count 1 sets forth the scheme. Paragraph 2 alleged Defendant engaged in a scheme to defraud Grand Met and Dorsey & Whitney by trading in Pillsbury, Inc. common stock, while in possession of material nonpublic information about Grand Met's future tender offer for Pillsbury common stock. In paragraph 14, it is alleged that Defendant, a partner in the firm of Dorsey

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[2] Defendant in his supplemental motion to dismiss revisits these issues arguing that Counts 21-54 of the Indictment must be dismissed "based upon the failure to charge an offense because the defendant did not possess any material non-public information at the time he placed the orders for the purchase of Pillsbury common stock and options identified in the indictment." *See* Defendant's Supplemental motion to Dismiss. Again these issues must be left to the trier of fact. This Court will not presage their decision.

& Whitney, learned his firm was retained by Grand Met to represent them in connection with tender offers and then purchased Pillsbury stock and call options, which he later sold at a profit after the tender offer became public information.

The allegations, read together and given a common sense interpretation, allege that Defendant defrauded Grand Met and Dorsey & Whitney by using, without permission, their confidential business information, before it became public, to trade in Pillsbury stock. Defendant's argument that the indictment fails to allege an essential element of the offense must be rejected.

In resolving the second issue, it must be determined whether the tender offer information was property within the meaning of the mail fraud statute. Defendant relies on *McNally v. United States*, 483 U.S. 350 (1987). In *McNally*, the Supreme Court held that the public's interest in honest and impartial government is not property within the meaning of the mail fraud statute. Defendant's apparent contention is that confidential information is not property subject to the mail fraud statute under *McNally*.

Defendant's premise was rejected in *Carpenter v. United States*, 484 U.S. 19 (1987). In *Carpenter*, the Supreme Court held that confidential business information is property within the scope of the mail fraud statute. *Id.* at 28. In *Carpenter*, the defendants had used information on the publication date and contents of a Wall Street Journal article to trade in the market, based on the probable impact on the market when the article was published. The distinction between *McNally* and *Carpenter* is not between tangible and intangible property, but between those interests which do not constitute property and those interests

that are either tangible or intangible property. *United States v. Grandberry*, 908 F.2d 278, 280 (8th Cir. 1990).

Under *Carpenter* Grand Met's confidential business information is property protected by the mail fraud statute. Law firms have a property interest in keeping information confidential to retain and gain clients. *United States v. Grossman*, 843 F.2d 78, 86 (2d Cir. 1988). Dorsey & Whitney also has a property interest protectable under the mail fraud statute. Defendant's motion must be denied at this time. The issue of whether the business information was confidential and misappropriated must await proof at trial.

FAILURE TO STATE AN OFFENSE—NOT IN FURTHERANCE

Defendant next moves to dismiss all of the mail fraud counts, 1 through 20, on the ground that the mailings alleged in each count were not in furtherance of the scheme to defraud as required by the mail fraud statute, 18 U.S.C. § 1341. Each count alleges the mailing to Defendant from his broker of a confirmation of Pillsbury stock or call option purchases. Defendant argues that the stock purchases were on record with his brokers and the confirmation slips were not required to prove ownership, nor were they ever used by him for any purpose, and thus did not further the scheme.

Defendant relies on *Kann v. United States*, 323 U.S. 88 (1944); *Parr v. United States*, 363 U.S. 370 (1960); *Maze v. United States*, 414 U.S. 395 (1974); and *United States v. Taylor*, 789 F.2d 618 (8th Cir. 1986). In *Kann*, the court held that mailing a check from the bank that cashed it to the drawee bank was not in

furtherance of a scheme to defraud because defendants had the money and it was immaterial to them whether the bank, which paid the check, could collect from the drawee bank. *See also United States v. Taylor, supra.* In *Parr* and *Maze*, the Supreme Court held that credit card invoices, mailed after the goods and services had been obtained, were not in furtherance of the scheme to defraud. In both cases, it was immaterial to the defendant whether the invoices were mailed, since he had completed his scheme.

The above cases are distinguishable from the instant case. The scheme here alleges that the Defendant bought Pillsbury stock based on confidential information and sold it later, when the information became public and drove up the price of the stock. The scheme alleged was therefore only half complete when the stocks were purchased. Businesses, including stock brokers, make errors when executing and recording transactions. The slips confirming the purchases would be important to settle disputes over the fact of or the amount of stock purchased. The slips would also be important in determining which blocks of stock or call options to sell in order to maximize profits when the price began to rise.

The Second Circuit in *United States v. Grossman*, 843 F.2d 78, 89 (2d Cir. 1988) held that confirmation slips were sent in furtherance of a scheme to defraud because:

> 1) They provided notification that the purchase was complete; 2) provided a tally of purchase, and 3) provided proof of ownership.

Defendant attempts to distinguish *Grossman* because the slips in that case were sent to defendant's rela-

tives to conceal ownership. The principles of *Grossman* are applicable, however, because of the factors listed above. Defendant's motion to dismiss because the confirmation slips were not in furtherance of the conspiracy must be denied.

FAILURE TO STATE AN OFFENSE—CRIMINALITY

Defendant contends that Counts 21-37 must be dismissed for failure to state an offense because Section 10(b) of the Securities Exchange Act of 1934 does not criminalize insider trading. This Court rejects Defendant's argument. Two cases are illustrative of this point.

In *United States v. Lang*, 766 F. Supp. 389, 399 (D. Md. 1991), the District Court found that insider trading was criminalized under Rule 10b-5, rejecting the type of argument that Defendant advances. More critically, in *SEC v. O'Hagan*, 793 F. Supp. 218, 221 (D. Minn. 1992), the District Court found that Rule 10b-5 prohibits insider trading, where the defendant argued that the SEC's claims were implied under *Lampf*, because Rule 10b-5 did not specifically prohibit insider trading. Given the confluence of *Lang* and *O'Hagan*, this Court must reject Defendant's argument. While Defendant criticizes the decision in *Lang*, in light of *O'Hagan*, it appears that the rule in this district is that Section 10(b), through the application of Rule 10b-5, criminalizes insider trading.

FAILURE TO STATE AN OFFENSE—FIDUCIARY DUTY

Defendant moves to dismiss Counts 21 through 37, which allege insider trading, because the counts fail to charge that he breached a fiduciary duty or other relationship of trust and confidence to Pillsbury stockholders, the target of Grand Met's takeover

offer. Defendant was neither an officer or director, nor did his law firm represent Pillsbury. Absent such a relationship, he argues he was free to trade in Pillsbury stock without disclosure of allegedly confidential information. The government counters Defendant violated Rule 10(b)-5, when he breached a duty to Grand Met and Dorsey & Whitney, its law firm, by misappropriating their confidential business information and using it to trade in the market.[3]

The Securities and Exchange Commission (SEC) in *In the matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) ruled that a corporate insider, who has material nonpublic information, must under Rule 10(b)-5 abstain from trading in his corporate stock unless he discloses the information known to him. The Supreme Court accepted and applied the principles of *Cady, Roberts* in *United States v. Chiarella*, 445 U.S. 222 (1980). In *Chiarella*, documents relating to a takeover bid had been sent to a company for printing. One of the printing company's employees deciphered the identity of the target company and profited from

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[3] Rule 10(b)-5, codified at 17 C.F.R. § 240-10b-5 (Employment of manipulative and deceptive devices), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which there were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud of deceit upon any person, in connection with the purchase or sale of any security.

trading in its stock, without disclosing the information he had learned. The court held there was no general requirement to disclose inside information, when trading in the market. *United States v. Chiarella*, 445 U.S. 222, 229 (1980). The Supreme Court reversed the criminal conviction for violating Rule 10(b)-5 because the printer, absent a fiduciary duty or a relationship of trust and confidence to the shareholders of the target company, owed no duty to disclose his information. The majority in *Chiarella* rejected the government's invitation to affirm the convictions because the printer had breached his duty to the tender offeror by misappropriating the information. In their view, the theory was not presented to the jury.

The SEC contended in *Dirks v. SEC*, 463 U.S. 464 (1983) that a broker, who received material nonpublic information from corporate officers and employees, which he gave to some of his customers, who traded in the stock, was in violation of Rule 10(b)-5. The SEC censured Dirks for the violation. The Supreme Court said at page 665:

> It is undisputed that Dirks himself was a stranger to Equity Funding with no preexisting fiduciary duty to its shareholders. He took no action, directly or indirectly, that enticed the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirks' sources that he would keep their information in confidence nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their *Cady, Roberts* duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty, when he passed it on to investors . . .

The court went on to hold that the tippers in *Dirks* did not breach any duty to Equity Funding shareholders and concluded, therefore, that Dirks, the tippee, was not in violation of Rule 10(b)-5.

Under the principles of *Chiarella* and *Dirks*, the government concedes Defendant cannot, as he contends, be prosecuted under Rule 10(b)-5 for failure to disclose inside information to Pillsbury stockholders. Defendant had no preexisting fiduciary to them, and he did nothing to induce the officers and directors of Pillsbury to place their trust and confidence in him. As far as Pillsbury stockholders were concerned, Defendant was free under *Chiarella* and *Dirks* to use the alleged inside information as he saw fit.

We turn to the question of whether Defendant violated Rule 10(b)-5 if, as charged, he breached a duty by misappropriating Grand Met's and Dorsey & Whitney's confidential business information, and without disclosure, used it to trade in Pillsbury stock. Stated another way, the question is whether Defendant can be convicted if neither the seller nor the buyer of securities was defrauded.

The Supreme Court has not addressed this question. As set forth above, the question was not answered in *Chiarella* or *Dirks*. In the former, because the issue was not presented to the jury. In the later, because there was no claim of misappropriation of information. In *Carpenter v. United States*, 484 U.S. 19 (1987), an equally divided court affirmed without opinion a Rule 10(b)-5 criminal conviction for the misappropriation of confidential business information of the Wall Street Journal, and its use to trade in the market based upon the impact on the market when the information became public. The misappropriation theory of insider trading posits that Rule 10b-5

prohibits the purchase or sale of securities while in possession of material, nonpublic information if it is a breach of a fiduciary duty owed to the source of the information, whether or not that source was involved in the security transaction and whether or not there was a breach of duty to any purchaser or seller. It is under this broader theory of insider trading that the government charges Defendant. While the Eighth Circuit has not specifically adopted the misappropriation theory, other circuits have.

In *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983), two employees at the Kuhn Loeb investment banking firm:

> Misappropriated confidential information concerning proposed mergers and acquisitions that was entrusted to their employers by corporate clients. This information was conveyed to Newman, a securities trader and manager of the over-the-counter trading department of a New York brokerage firm. Newman passed along the information to two confederates . . . [T]he three conspirators purchased stock in companies that were takeover targets . . . They then reaped substantial gains when the mergers or takeovers were announced and the market price of the stock rose.

United States v. Newman, 664 F.2d 12, 15 (2d Cir. 1981). The district court dismissed the securities fraud charges because it concluded the federal securities laws did not proscribe the defendants' conduct. In reversing the district court, the Second Circuit reasoned, first, that § 10(b) was written as both a regulatory and criminal piece of legislation, going on to note that, "The courts, not the Congress, have limited Rule 10(b)-5 suits for damages to the purchas-

ers and sellers of securities. The district court's statement that fraud perpetrated upon purchasers or sellers of securities is a 'requisite element under the securities laws' is, therefore, an overbroad and incorrect summary of the law." *Id.* at 17. The court than noted that a plaintiff, "need not be a defrauded purchaser or seller in order to sue for injunctive relief under Rule 10(b)-5." *Id.* Finding that the defendants had wronged both the investment firm and their clients by misappropriating the confidential information, the court concluded:

> In other areas of law, deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful. (citations omitted). Appellee would have had to be most ingenuous to believe that Congress intended to establish a less rigorous code of conduct under the Securities Acts. (citations omitted).

Id. at 18.

In *Rothberg v. Rosenbloom*, 771 F.2d 818 (3rd Cir. 1985), *cert. denied*, 481 U.S. 1017 (1987), officer and director, David Rosenbloom obtained information that his company, Nytronics, intended to merge with Gulton Industries. Rosenbloom conveyed this information to Rothberg, who invested on the basis of this information. The trial court held that Rosenbloom breached a duty to his own company, whether or not be breached a duty to Gulton shareholders.

On appeal, it was contended that, "with respect to the Gulton transaction, he was an outsider and could not have violated § 10(b), relying on *Chiarella*." *Id.* at 822. The Third Circuit found *Chiarella* inapposite, holding that Rosenbloom owed a fiduciary duty to his

own company, Nytronics, "not to disclose secret information which would cause others to buy Gulton stock, thereby making it more difficult for Nytronics to consummate a merger on favorable terms." *Id.* Citing *Newman*, the court upheld the trial court, holding that: "An insider on either side of a proposed transaction violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality." *Id.*

In *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990), Clark was president of Rolyan Manufacturing. Rolyan was acquired by Smith & Nephew, plc, (S&N), a British concern. S&N employed Clark as part of an acquisitions team to find new companies for S&N to acquire. Through his employment with S&N, Clark discovered that S&N intended to acquire Affiliated Heath Products (AHP). Acting on the basis of this information, Clark arranged to purchase AHP stock in anticipation of the takeover. In the trial court, Clark was found in violation Rule 10(b)-5 under a misappropriation theory. On appeal, the Third Circuit stated that, "Our task is to determine whether Congress, in enacting § 10(b), empowered the SEC to promulgate rules which would encompass the misappropriation theory. In addition, we must determine whether Rule 10b-5 was drafted such that the theory may legitimately be implied." *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990).

Discussing *Newman*, *Rothberg* and a number of other cases upholding the misappropriations theory, the Court upheld the application of the misappropriation theory reasoning:

1. Rule 10(b)-5 is a "catchall" antifraud provision, *id.* at 448;

2. The misappropriation theory fits "comfortably" within the concept of fraud in § 10(b) and Rule 10(b)-5, *id.* at 449;

3. Clark's actions were in connection with the purchase or sale of any security because, "Clark's sole purpose in obtaining the non-public information about SN's plans to acquire AHP was to make a fast buck by trading in securities," *id.*;

4. "[T]he scant legislative history on § 10(b) contains no indication that the misappropriation theory is out of step with congressional intent." *Id.* at 450. The court found the same to be true for Rule 10(b)-5; and

5. Looking to the passage of the Insider Trading and Securities Fraud Enforcement Act of 1988, the court found that Congress had manifested a belief that the misappropriation theory was consistent with § 10(b) and Rule 10(b)-5, noting the House Report on this legislation. *Id.* at 452.

The Ninth Circuit concluded that:

> The "peculiar blend of legislative, administrative, and judicial history" surrounding § 10(b) and Rule 10(b)-5, (citation omitted), provides strong evidence that the misappropriation theory is compatible with the broad language of those provisions. Although the Supreme Court has yet to recognize the theory, (footnote omitted) we nonetheless adopt it as it was prosecuted in this case. Specifically, we hold that an employee's knowing misappropriation and use of his employer's material nonpublic information regarding its intention to acquire another firm constitutes a violation of § 10(b) and Rule 10(b)-5.

* * *

> [While] Clark . . . claims that adopting the theory in this case would introduce a "parity-of-information" rule which has been previously rejected by the Supreme Court as inconsistent with § 10(b) and Rule 10(b)-5, *see Dirks*, 463 U.S. at 654, 103 S.Ct. at 3261; *Chiarella*, 445 U.S. at 233, 100 S.Ct. at 1117. (footnote omitted). We disagree. The misappropriation theory, as we have adopted it today, applies only where the misappropriation occurs by means of a violation of fiduciary or similar duty. (footnote omitted). Thus it does not run afoul of Supreme Court precedent.

Id. at 453.

In *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S.Ct. 966 (1992), Cherif was employed by First National Bank of Chicago. After being terminated from his employment, Cherif retained his magnetic identification card, which he used to enter the building. Using this card, Cherif gained unauthorized access to the building after his termination and obtained confidential information from the Specialized Finance Department. Cherif then traded on this information.

In upholding the application of the misappropriation theory to Cherif, the Seventh Circuit stated:

> The misappropriation theory has won adherents in numerous circuit and district courts despite the lack of explicit approval from the Supreme Court. The bulk of the cases have arisen in the Second Circuit, (citations, to include *Newman*, omitted), but the theory has now been adopted by the Third and Ninth Circuits. (citations to *Clark* and *Rothberg* omitted). District courts in other circuits have welcomed the theory, too. *SEC v. Peters*, 735 F. Supp. 1505 (D. Kan. 1990); *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. 1989).

We join these courts in holding that a person violates Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934 by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment. There is a common sense notion of fraud behind the misappropriation theory. As the *Clark* court put it:

> [By] becoming part of a fiduciary or similar relationship, an individual is implicitly stating that she will not divulge or use to her own advantage information entrusted to her in the utmost confidence. She deceives the other party by playing the role of the trustworthy employee or agent; she defrauds it by actually using the stolen information to its detriment.

Clark, 915 F.2d at 448. We agree that buying or selling securities "in connection with" fraud perpetrated on an employer to obtain material nonpublic information constitutes a violation of Rule 10b-5. (footnote omitted).

SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991). The court applied the theory, even though Cherif was not employed by First National at the time he misappropriated the confidential information.[4]

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[4] The Court noted:

> Cherif was bound by a broader common law duty. This common law duty obligates an employee to protect any

Most recently, the Second Circuit has reaffirmed *Newman*, upholding convictions where:

> Appellant's convictions are based on the so-called misappropriation theory arising out of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). (footnote omitted). Sitting *in banc*, we recently restated that theory[:] "[O]ne who misappropriated nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5." *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (*in banc)* (citation omitted), *cert. denied*, ___ U.S. ___, 112 S.Ct. 1759,

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> confidential information entrusted to him by his employer during his employment. In addition, an employee is obligated to continue to protect such information after his termination.
>
> * * *
>
> Cherif breached a continuing duty to his former employer when he used the key card and specific, confidential knowledge he had learned about First Chicago as an employee to break into the bank immediately after termination and steal inside information about upcoming transactions. It makes no difference that Cherif carried out the thefts formally after his employment ended. The confidential property and information he came to possess during his tenure at the bank provided the foundation for the success of the subsequent break-ins. Cherif attained his objective of obtaining deal-specific information by wrongfully converting other confidential information entrusted to him by First Chicago. His trades were "in connection with" a fraudulent scheme to gain access to material, non-public information possessed by first Chicago. This is all the nexus that Rule 10b-5 requires.

Id. at 411.

118 L. Ed. 2d 422 (1992); *see also id.* at 576 ("[L]ower courts have added to the *Dirks* [*v. SEC*, 463 U.S. 646, 103 S.Ct. 3255, 77 L. Ed. 2d 911 (1983),] breach of duty doctrine a misappropriation of information doctrine, which prohibits trading in securities based on material, nonpublic information acquired in violation of a duty to any owner of such information, whether or not the owner is the corporation whose shares are traded.") (Winter J., concurring and dissenting opinion). We have found the requisite fiduciary duty in the employer/employee context. (citation omitted). We have also noted that "the misappropriation theory does not require that the buyer or seller of securities be defrauded." *Chestman*, 947 F.2d at 566. Rather, "the predicate act of fraud may be perpetrated on the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities." *Id.* This fraud has been analogized to embezzlement, *see Carpenter*, 791 F.2d at 1033 n. 11, and may simply be thought of as the misuse, by trading, of stolen information. *See Chestman*, 947 F.2d at 578 (Winter, J., concurring and dissenting opinion).

United States v. Libera, 989 F.2d 599-600 (2d Cir. 1993). This Court is persuaded by the reasoning of the cases from the Second, Third, Seventh and Ninth Circuits adopting the misappropriation theory. This Court finds that Defendant can be convicted of having violated Rule 10(b)-5 if, as charged, he breached a duty by misappropriating Grand Met's and Dorsey & Whitney's confidential business information, and without disclosure, used it to trade in Pillsbury stock, even

though neither the seller nor the buyer of securities was defrauded.[5]

STATUTE OF LIMITATIONS

Defendant argues that the securities fraud Counts, 21-54, must be dismissed because they are barred by the statute of limitations. The conduct at issue in these Counts took place in August and September of 1988. The pending indictment was handed down on December 17, 1992. Defendant argues that the applicable statute of limitations is that announced in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct 2773, 2782 (1991); one year after

[5] Defendant's subsidiary argument that the misappropriation theory invades the exclusive province of state law is without foundation. While state law may well regulate Defendant's acquisition of the confidential information at issue, and the ethical propriety of such actions, federal law addresses the use of that information. Defendant cites no Minnesota statutory scheme that will be disrupted by the application of Rule 10(b)-5 to Defendant's use of the confidential information. The fraud encompassed by Section 10(b) and Rule 10b-5 extends to conduct which touches the purchase or sale of securities. *See Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6, 12-13 (1971); *see also United States v. Gruenberg*, 898 F.2d 971 (8th Cir. 1993). This touching requirement has been interpreted broadly and reaches Defendant's conduct. *See SEC v. Cherif*, 933 F.2d at 411; *SEC v. Clark*, 915 F.2d at 449; *United States v. Newman*, 664 F.2d at 18.

Similarly, Defendant's argument that Section 10(b) and Rule 10b-5 are void for vagueness with respect to the misappropriation theory because they do not provide fair notice of prosecution and violate due process has been rejected. *See United States v. Newman*, 664 F.2d at 19; *United States v. Lang*, 766 F. Supp. at 402. In light of the cases discussed, *supra*, this Court must agree.

discovery and within three years after the violation. The government argues that the applicable statute of limitations is five years, as set out in 18 U.S.C. § 3282. This Court finds that *Lampf* is inapplicable to this case and the appropriate statute of limitations is that set out at 18 U.S.C. § 3282.

The Supreme Court's decision in *Lampf* only applies to private actions based on Section 10(b) of the Securities Exchange Act of 1934. This is the context in which *Lampf* arose and the Court noted that "in this litigation we must determine which statute of limitations is applicable to a *private* suit brought pursuant to § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b), and to Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10-b-5 (1990), promulgated thereunder." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct. 2773, 2776 (1991) (emphasis added). As the instant suit is brought by the government, *Lampf* is inapplicable.

Moreover, *Lampf* applies only to implied, not express, causes of action. *Id.* at 2779-80. This Court has found that "[A]n SEC enforcement action is . . . express, not implied, regardless of whether judicial interpretation has broadened the rule which the SEC seeks to enforce." *SEC v. O'Hagan*, 793 F. Supp. 218, 221 (D. Minn. 1991). As this action is an SEC enforcement action it is express and *Lampf* has no application.

As the 1934 Act does not provide for a specific statute of limitations the catch-all five year statute of limitations for offenses not capital, 18 U.S.C. § 3282, applies. *See e.g., United States v. Vogt*, 910 F.2d 1184, 1195 (4th Cir. 1990) (RICO); *United States v. Thomas*, 887 F.2d 1341, 1349 (9th Cir. 1989) (Lacey Act); *United*

States v. Pepe, 747 F.2d 632, 663 (11th Cir. 1984) (RICO); *United States v. Sloan*, 389 F. Supp. 526, 528 (S.D.N.Y. 1975) (Exchange Act); *United States v. Bloom*, 78 F.R.D. 591, 598 (E.D. Pa. 1977) (same).

MULTIPLICITY OF COUNTS

Defendant contends that Counts 21-54 are multiplicitous and should be consolidated into two or three counts. Defendant is in error. Multiplicitous counts charge a single offense in several counts. *See United States v. George*, 986 F.2d 1176, 1179 (8th Cir. 1993). Defendant argues that he only made three stock orders and only once formulated the intent to commit fraud. Therefore, he reasons, the counts reflecting the purchases, as carried out by his brokers, are multiplicitous. Defendant's allegations are unproven assertions of fact that will ultimately be determined at trial.

Assuming, *arguendo*, that Defendant's characterization of his behavior is true, the Counts are not multiplicitous. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975), the Supreme Court identified the actual purchase or sale of a security as the operative event for purposes of Section 10(b) liability. Thus, the intent to commit fraud and the placement of the orders by themselves are irrelevant as orders do not violate Section 10(b) without a purchase or sale taking place. The general principle of charging a defendant with each sale of a security as a separate offense has been upheld by the Eighth Circuit. *See United States v. Naftalin*, 606 F.2d 809, 810 (8th Circuit 1979) (prosecution under Section 17(a) of the Securities Act of 1933); *see also United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990).

SEC'S AUTHORITY TO PROMULGATE RULE 14e-3

Defendant contends that Counts 38-54 of the indictment, charging Defendant with violating Section 14e and Rule 14e-3 of the 1934 Act, must be dismissed because the SEC exceeded its rulemaking authority in promulgating Rule 14e-3. Section 14e provides in pertinent part:

> (e) It shall be unlawful for any person to . . . engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . The Commission shall, for purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative.

15 U.S.C. § 78n(e).

Rule 14e-3 reads in pertinent part:

> (a) If any person has taken a substantial step or steps to commence, or has commenced a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from: . . .

> (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a). Defendant's argument has been considered and rejected. *See United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991); *United States v. Marcus Schloss & Co., Inc.*, 710 F. Supp. 944 (S.D.N.Y. 1989). This Court finds these cases persuasive and declines Defendant's invitation to find that these cases were wrongly decided.

FAILURE TO STATE AN OFFENSE—SUBSTANTIAL STEPS

Defendant contends that Counts 38-54 of the indictment must be dismissed for failure to state an offense because the indictment fails to allege that Grand Met took substantial steps toward the takeover of Pillsbury, as required by Rule 14e-3. *See supra*. Defendant is in error. The indictment alleges that Grand Met formulated an intent to takeover Pillsbury and then set about taking steps to implement that plan to include soliciting advice and arranging for financing. *See* Indictment, Docket No. 1, pp. 14-15.

While Defendant argues that, since no specific price is referenced, no substantial steps can be found to have been taken, this argument is unsupported by case law and defies common sense. Similarly, Defendant's argument that, due to evidence relating to Grand Met's financing of the takeover, the steps undertaken by Grand Met cannot be considered substantial, is premature, being clearly an issue for trial.

FAILURE TO STATE AN OFFENSE—UNLAWFUL ACTIVITY

Defendant contends that Counts 55-56 must be dismissed for failure to state an offense because neither mail fraud nor securities fraud were defined as "specified unlawful activity" in 1988, pursuant to the money laundering statutes under which Defendant is charged, 18 U.S.C. § 1957 (Count 55) and 18 U.S.C. § 1956(a)(1)(B)(i) (Counts 56 and 57). Defendant is in error.

Defendant committed his alleged illegal acts in August and September of 1988. As of that time 18 U.S.C. § 1956(c)(7)(A) defined the necessary predicate acts for liability under the statute to include any act listed in 18 U.S.C. § 1961(1). Similarly, as of that time 18 U.S.C. § 1957(f) (3) defined the necessary predicate acts for liability under the statute as the same as those in § 1956, thus including any act listed in 18 U.S.C. § 1961(1).

As of the date of Defendant's alleged illegal activity, § 1961(1) included the mail fraud statute, § 1341, and any offense involving "fraud in the sale of securities." "Fraud in the sale of securities" includes conduct proscribed by Section 10 and Rule 10b-5. *See e.g., James v. Meinke*, 778 F.2d 200, 204-05 (5th Cir. 1985);

Ohman v. Kahn, 685 F. Supp. 1302, 1309-10 (S.D.N.Y. 1988) (RICO). Thus, Defendant's argument does not hold water as both mail fraud and fraud in the sale of securities were defined as "specified unlawful activity" in 1988, pursuant to the money laundering statutes under which Defendant is charged, 18 U.S.C. § 1957 (Count 55) and 18 U.S.C. § 1956(a)(1)(B)(i) (Counts 56 and 57).

RECOMMENDATION

Accordingly, **IT IS HEREBY RECOMMENDED** that Defendant's motion to dismiss the indictment and his supplemental motion to dismiss be **DENIED**.

/s/ J. EARL CUDD
HON. J. EARL CUDD
UNITED STATES MAGISTRATE JUDGE

Dated: Sept. 10, 1993

Pursuant to Local Rule 72.1(c) any party may object to this Report and Recommendation by filing with the Clerk of the Court, and serving all parties within ten (10) days, a writing which specifically identifies those portions of this Report to which objections are made and the basis of those objections. Failure to comply with this procedure shall operate as a forfeiture of the objecting party's right to seek review in the Court of Appeals.

Unless the parties are prepared to stipulate that the District Court is not required by 28 U.S.C. § 636 to review a transcript of the hearing in order to resolve all objections made to this Report and Recommendation, the party making the objections shall timely order and cause to be filed a complete transcript of the hearings.

APPENDIX C

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

No. 4-92-CR-219

UNITED STATES OF AMERICA

v.

JAMES HERMAN O'HAGAN

[FILED: DEC. 30, 1993]

ORDER

This matter is before the Court on appeal from Reports and Recommendations issued by the Honorable J. Earl Cudd, United States Magistrate Judge, on September 1, 1993, and September 10, 1993. In the September 1, 1993, report, the magistrate recommended that defendant's motion to dismiss Counts 21 through 54 of the indictment for improper venue be denied. The September 10, 1993, report recommended that defendant's motion to dismiss the indictment be denied. As part of this report and recommendation, the magistrate ruled, *inter alia*, that the Double Jeopardy Clause of the Fifth Amendment did not bar this prosecution. The defendant filed objections to the report and recommendations, pursuant to Local Rule 72.1(c).

Based upon a *de novo* review of the record herein, the Court adopts the magistrate's reports and recommendations.

* * * * *

Conclusion

For the reasons set forth above, and based on all files, records, and proceedings, IT IS ORDERED that:

1. Defendant's motion to dismiss Counts 21 through 54 of the indictment for improper venue is denied.

2. Defendant's motion to dismiss the indictment, and his supplemental motion to dismiss, is denied.

3. Jury selection in this matter will commence, as previously determined, on January 3, 1994, and trial will commence January 11, 1994.

Dated: December 30th, 1993

/s/ JAMES M. ROSENBAUM
JAMES M. ROSENBAUM
United States District Judge

APPENDIX D

UNITED STATES COURT OF APPEALS
EIGHTH CIRCUIT

Nos. 94-3714, 94-3856MNMI

UNITED STATES OF AMERICA,
PLAINTIFF-APPELLEE/CROSS-APPELLANT

v.

JAMES HERMAN O'HAGAN,
DEFENDANT-APPELLANT/CROSS-APPELLEE

[Filed: Nov. 13, 1996]

ORDER DENYING PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

The suggestion for rehearing en banc is denied. Judge McMillian would grant the suggestion.

The petition for rehearing by the panel is also denied.

Chief Judge Richard S. Arnold, Judge Magill, Judge Loken, and Judge Murphy took no part in the consideration or decision of these cases.

Order Entered at the Direction of the Court:

/s/ MICHAEL E. GANS
MICHAEL E. GANS
Clerk, U.S. Court of
Appeals, Eighth Circuit

APPENDIX E

STATUTES AND REGULATIONS

1. Section 1341 of Title 18, United States Code, states follows:

§ 1341. Frauds and swindles

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

2. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. 78j, states, in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerceor of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), states:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The [Securities and Exchange] Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

4. Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5 (1983), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

5. Rule 14e-3(a) of the Securities and Exchange Commission, 17 C.F.R. 240.14e-3, provides:

Rule 14e-3(a) provides:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the [Securities Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

(3) Any officer, director, partner, or employee or any other person acting on behalf of the offering person or such issuer,

to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.